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In the Supreme Court of the United States

OCTOBER TERM, 1953

No. 530

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

C. P. CHAMBERLIN,[1] GRACE A. CHAMBERLIN, JOHN H. TONER, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Acting Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that

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[1] These cases involve income tax liability of six individuals who owned practically all of the common stock of the same corporation. The cases present a common issue, and were consolidated for hearing both in the Tax Court and the court below. (R. 51-52, 81.) The record was made and filed below only in the case of *C. P. Chamberlin* v. *Commissioner*, with the stipulation that the decision in that case is to govern the decision in the others. (R. 81-83.) A separate judgment was entered in each case. (R. 87-91.) For convenience the cases will be referred to in the singular, while the respondents will sometimes be collectively referred to as the taxpayers or the stockholders.

writs of certiorari issue to review the judgments of the Court of Appeals for the Sixth Circuit, reversing the decisions of the Tax Court in the instant cases.

OPINIONS BELOW

The opinion of the Tax Court (R. 51-78) is reported at 18 T.C. 164. The opinion of the Court of Appeals (R. 91-103) is reported at 207 F. 2d 462.

JURISDICTION

The judgments of the Court of Appeals were entered on October 14, 1953. (R. 87-91.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Preferred stock was issued to the common stockholders of a corporation in the form of a stock dividend, and was contemporaneously transferred by them to previously selected purchasers on previously negotiated terms for a cash price equal to the par value of the dividend stock, both steps being taken in execution of a preconceived plan for avoiding a dividend tax on a direct distribution of the corporation's accumulated earnings. The question is whether the stockholders received a dividend distribution taxable under Section 115(a) and (b) of the Internal Revenue Code, as the Tax Court held, or a non-taxable stock dividend under Section 115(f), as the Court of Appeals held.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations appear in the Appendix, *infra,* pp. 26-29.

STATEMENT

The facts as stipulated (R. 34-50) and found by the Tax Court (R. 52-63) may be summarized as follows:

Taxpayers owned 99.7 per cent of the outstanding common stock of the Metal Mouldings Corporation (hereafter called the Metal Company or the corporation), a Michigan corporation long engaged in the manufacture of metal mouldings and trim used in automobiles. Two of the taxpayers, C. P. Chamberlin and his wife, together owned 83.8 per cent of the stock, and were respectively the president and secretary of the corporation. Together with another taxpayer they constituted three of the four directors of the corporation. (R. 52-53.)

The corporation enjoyed substantial net earnings in each year from 1937 through 1945, paid cash dividends in those years, and had a substantial earned surplus at the end of 1945. For the first six months of 1946 the net profits after taxes amounted to $215,184.84, and for the entire year 1946 they amounted to $664,798.30. As of June 30, 1946, the corporation's balance sheet reflected total assets of $2,488,836.53, including $1,272,354.56 in cash and Government securities, of which $1,267,566.77 represented earned surplus. (R. 54, 57-58.)

In the latter part of 1945 a representative of the corporation conferred with one Flower, partner of an investment banking firm, regarding income tax problems of the corporation and its stockholders. It was explained that because of its large accumulated earned surplus the corporation was fearful

of being subjected to the surtax imposed by Section 102 of the Internal Revenue Code, and that C. P. Chamberlin, the majority stockholder, was unwilling to have the corporation distribute any substantial portion of the earned surplus as ordinary dividends because his individual income was taxable at high surtax rates. Advice was sought as to a means whereby the stockholders could derive cash benefits from the corporation's earned surplus in the form of capital gains rather than as taxable dividends. Flower suggested capitalization of a million dollars of the earned surplus through issuance of preferred stock, subject to provisions for rapid retirement, as a stock dividend to the stockholders, and an immediate sale of the preferred stock to an insurance company for cash. Chamberlin assented to this plan, and Flower then discussed it with an official of the Lincoln National Life Insurance Company. The latter stated he was interested if terms satisfactory to Lincoln could be worked out. Thereafter Chamberlin sought and received legal advice on the proposed plan, and in October 1946 Lincoln was advised of the Metal Company's willingness to make any reasonable covenants for the protection of the preferred stock, and of its wish to proceed with the plan before the end of the year. Shortly thereafter the Lincoln official inspected the plant and business of the Metal Company, discussed the proposed plan, and suggested amendments in accordance with Lincoln's investment policy. On November 11, 1946, that official made a detailed report to Lincoln regarding

the Metal Company's facilities, operations and earnings. His report stated, among other things, that the "purpose of this [issue of preferred stock] is to enable the owners to take money out of the company and to pay thereon a capital gains tax of 25 per cent rather than the normal personal income tax rates"; and that the negotiated terms of the preferred stock "seek to give the degree of protection usually found in a first lien bond issue." (R. 61-62.)

On November 20, 1946, Lincoln wrote to Flower that its finance committee approved of an $800,000 preferred stock issue and the purchase of one-half thereof on prescribed terms as to dividend rate, sinking fund, etc. Thereupon Flower communicated with the Northwestern Mutual Life Insurance Company, giving all the details of the plan and soliciting Northwestern's purchase of the other one-half of the proposed preferred stock issue. Northwestern made a detailed investigation of the Metal Company and of the terms and conditions of the proposed stock issue. About the middle of December its committee on investments approved the purchase of $400,000 of the preferred stock and turned the matter over to its legal department for consummation of the transaction. (R. 62-63.)

On December 16, 1946, the taxpayers authorized an increase of the Metal Company's authorized capital stock from $150,000 to $650,000, represented by 6,500 shares of $100 par value common stock, and a certificate to that effect was duly filed. On December 20, a common stock dividend was issued

to the taxpayers, resulting in an increase in the outstanding common stock from 1,002.5 to 6,015 shares, and a transfer of $501,250 of the corporation's surplus to capital account. (R. 54.)

On December 26, 1946, pursuant to the prior negotiations and the prearranged plan, taxpayers authorized an increase of the authorized capital stock of the Metal Company to a total of 14,520 shares of all classes of stock, consisting of 8,020 shares of four and one-half percent cumulative $100 par value preferred and 6,500 shares of $100 par value voting common. A certificate amending the corporation's charter to that effect was filed December 27. On the following day, December 28, pursuant to resolutions adopted by the stockholders and directors, a stock dividend of one and one-third shares of the newly authorized preferred stock was issued for each share of common outstanding, and the corporation's accounts were adjusted by transferring the par value of the preferred stock so issued (a total of $802,000) from earned surplus to capital account. On the same date, temporary typewritten preferred stock certificates were issued to taxpayers. (R. 54-56, 61.)

The preferred stock contained numerous terms and conditions designed to protect the holders. Among other things, the corporation reserved the right to redeem the shares in whole or in part on any dividend date, and it was required to redeem them between 1948 and 1954 in the amount of 2,000 shares in 1948 and 1,000 shares annually thereafter. (R. 55.)

On December 30, 1946, also as the result of the prior negotiations, the taxpayers signed a "Purchase Agreement" with the two insurance companies. It provided that the taxpayers "hereby confirm their agreement" for the sale of 4,000 shares of preferred stock to each of the insurance companies, at a cash price equal to the par value ($100 per share) plus dividends accrued to the date of delivery. Each of the insurance companies likewise "confirmed and accepted" that agreement. The Metal Company signed an endorsement of the agreement for the stated purpose of making "to and with" the insurance companies "the representations, warranties and agreements contained" in enumerated sections of the agreement and relating to the Metal Company's operations and financial condition. On the same day, December 30, taxpayers delivered the temporary preferred stock certificates endorsed in blank to the agents of the two insurance companies. The latter paid the purchase price to Chamberlin, who after deducting expenses incident to the sale distributed the cash proceeds pro rata among the taxpayers. On the same day, the temporary preferred stock certificates were delivered to and canceled by the corporation, and new temporary certificates were issued to the insurance companies. In April of the following year these temporary certificates were replaced by definitive stock certificates. (R. 58-60.)

Both the issuance of the preferred shares as a stock dividend to taxpayers, and the latters' imme-

diate sale of the dividend shares to the insurance companies, were the culmination of the prior negotiations directed toward that result. (R. 61.) No formal purchase agreement was entered into with the insurance companies prior to the "Purchase Agreement" executed on December 30, 1946. However, the stockholders and directors of the corporation took the necessary steps to put the negotiated plan into effect only after the insurance companies signified their willingness to purchase the preferred stock if, as, and when it was issued on the terms and conditions prescribed by them, and as set out in the corporation's amended charter and in the "Purchase Agreement" executed on December 30, 1946. (R. 63.)

In 1949 the authorized preferred stock of the Metal Company was decreased by 2,000 shares which had previously been retired. In 1950 the authorized preferred stock was again decreased by an additional 1,000 shares which had also been retired. (R. 60-61.)

In their 1946 income tax returns each of the taxpayers reported his proportion of the cash proceeds derived from the issuance and concurrent sale of the preferred stock as net long-term capital gain. The Commissioner determined that the amount received by each taxpayer constituted a dividend taxable as ordinary income. (R. 63.) The Tax Court, one judge dissenting, sustained the Commissioner's determination. (R. 64-78.) The Court of Appeals reversed. (R. 103.)

SPECIFICATION OF ERRORS TO BE URGED

The Court of Appeals erred:

1. In failing to apply to the facts of this case the established principle that the substance rather than the form of a transaction is determinative of its tax effect.

2. In holding that the Tax Court was precluded from finding that the issuance of the preferred stock to the taxpayers and the concurrent retransfer of the stock for cash to previously selected purchasers on previously negotiated terms, pursuant to a preconceived tax avoidance plan, were component steps of a single integrated transaction.

3. In substituting its inferences of fact for those of the Tax Court.

4. In holding that the transaction here involved resulted in the receipt by taxpayers of a non-taxable stock dividend.

5. In reversing the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

This case presents the important question of whether the controlling stockholders of a corporation may defeat the dividend tax by disguising what in substance and effect is a cash distribution of corporate earnings as a stock dividend and a sale of the dividend stock. Looking through form to substance, the Tax Court concluded that what appeared superficially to be two separate and distinct transactions—the issuance of a preferred stock dividend to the taxpayers-stockholders, followed by a sale of the stock to third parties—were actually

interrelated component steps in a single prearranged transaction, the avowed purpose of which was tax avoidance and the net result of which was to place the preferred stock in the hands of the purchasers, place the cash purchase price in the hands of the taxpayers, and reduce the corporation's accumulated earnings in the same amount.

The Court of Appeals, isolating the issuance of the preferred stock to the taxpayers from their concurrent retransfer of it to the purchasers, and treating the two steps as if they were unconnected events each having separate tax significance, reversed the Tax Court. It held that the taxpayers received a true stock dividend and, moreover, the kind of stock dividend which did not represent income constitutionally subject to tax. In so holding, the court below violated the fundamental principle, established by many decisions of this Court, that tax consequences flow from the substance rather than the form of a transaction. And it departed from the equally established rule that whether various steps in a transaction are in fact separate or interrelated presents a question of fact for the trial tribunal. The decision below sanctions a transparent attempt by stockholders of a closely held corporation to circumvent dividend tax liability through issuance of what is in form a stock dividend but is in substance a cash distribution of corporate earnings. If permitted to stand, it will invite widespread adoption of similar tax avoidance schemes, and result in serious loss of revenue.

1. Section 22 (a) of the Internal Revenue Code (Appendix, *infra*, p. 26) requires the inclusion

of "dividends" in gross income. Section 115 (a) (Appendix, *infra*, p. 26) defines a dividend as *any* distribution by a corporation to its shareholders, whether in money or other property, out of either accumulated or current earnings. By virtue of Section 115(b) (Appendix, *infra*, pp. 26-27), every distribution is deemed made out of earnings to the extent that the corporation has earnings. These provisions are qualified by Section 115(f) (Appendix, *infra*, p. 27), which provides in effect that a distribution in stock of the corporation is to be treated as a dividend only to the extent that it constitutes "income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution." See, also, Sections 29.115-1 and 29.115-7 of Treasury Regulations 111 (Appendix, *infra*, pp. 28-29). The provisions of Section 115(f) come into play only where there is a bona fide stock dividend, and whether such a dividend constitutes taxable income depends on whether it produces a change in the pre-existing proportionate interests of the stockholders. *Eisner* v. *Macomber*, 252 U. S. 189; *Koshland* v. *Helvering*, 298 U. S. 441; *Helvering* v. *Gowran*, 302 U. S. 238; *Helvering* v. *Griffiths*, 318 U. S. 371; *Helvering* v. *Sprouse*, 318 U. S. 604; *Strassburger* v. *Commissioner*, 318 U. S. 604. [2]

Addressing itself to the "substance of the trans-

[2] In the *Macomber* case, the Court said (p. 206) that the test of whether a stock dividend constitutes taxable income must be applied "according to truth and substance, without regard to form," and it emphasized (p. 211) that it was "considering the taxability of *bona fide* stock dividends only." The history of the taxation of stock dividends is summarized in the Tax Court's opinion. (R. 66-69.)

action" (R. 70), and pointing out that the "real purpose of the issuance of the preferred shares was concurrently to place them in the hands of others not then stockholders" (R. 72), the Tax Court concluded from all the evidence that the preferred stock dividend "was not a true stock dividend, but the equivalent of a cash dividend distribution out of available earnings" (R. 73). This conclusion is unquestionably warranted by the evidentiary facts.

Taxpayers were the common stockholders of a family corporation which had an earned surplus of more than a million dollars in cash and other liquid assets. They wished to derive the benefit of a cash dividend, but because their individual incomes were taxable at high surtax rates they also wished to escape the dividend tax to which they would be subject upon a direct distribution of the corporate earnings. In the hope of achieving both objectives, they devised a plan whereby they would cause the corporation to issue a preferred stock dividend, which they would simultaneously sell to third parties for cash. Pursuant to this plan, they negotiated with two insurance companies for a sale of preferred stock to be issued by the corporation. The negotiated terms of the proposed preferred stock issue were designed to afford the insurance companies the same degree of protection accorded holders of first lien bonds. The corporation reserved the right to redeem the stock at any time, and was required to do so within seven and a half years. After all the material

terms and conditions of the proposed preferred stock were negotiated with and approved by the insurance companies, both steps in the plan were executed: shares of preferred stock of a par value of $800,000 were issued to taxpayers, and the shares were contemporaneously sold to the previously selected purchasers upon the previously negotiated terms for an equal amount of cash.

The preliminary issue of the preferred stock to the taxpayers served no corporate or business purpose. The transaction admittedly was couched in the form of a stock dividend and a resale of the dividend stock in an attempt to relieve taxpayers of the dividend tax. Not a single practical result was accomplished by having the taxpayers take title to the stock, only to retransfer it to the purchasers, which would not have been achieved by having the corporation sell the stock directly to the purchasers. At the conclusion of the transaction the insurance companies owned $800,000 par value preferred stock, taxpayers received cash of an equivalent amount, and the corporation's earned surplus was decreased (and its capital increased) in the same amount. This was precisely the situation in which the parties would have found themselves had the corporation sold its preferred stock directly to the insurance companies and distributed the cash proceeds as a dividend.

Under the circumstances, the Tax Court was fully justified in concluding that the issuance of the preferred stock to taxpayers was not a bona fide stock dividend, the taxability of which is to be

tested by Code Section 115 (f) and cases dealing with genuine stock dividends. The distribution was clearly a taxable dividend within the purview of Section 115 (a) and (b). The transitory ownership of the dividend stock by taxpayers, and the circuitous routing of title to the purchasers, were steps designed to cloak the true nature of the transaction. If, as has been frequently stated by this Court, tax consequences depend on economic realities rather than on formal technical arrangements adopted for purposes of tax avoidance, the Tax Court should not have been reversed. The conclusion is inescapable that what really occurred here was a sale by the corporation of the new preferred stock to the insurance companies; the stockholders acted merely as a conduit of title from their corporation to the purchasers, while the purchase price payable to the corporation was deducted from its earned surplus and paid over directly to the stockholders.

2. In disagreeing with the Tax Court, the court below in effect rested its decision upon a combination of two theories: (1) the issuance of the preferred stock to taxpayers must be treated as a transaction separate and distinct from the concurrent transfer of the stock to the purchasers, and hence must be viewed as a true stock dividend for purposes of applying Section 115 (f); (2) so viewed, the stock dividend did not represent constitutionally taxable income in taxpayers' hands, and, hence, was exempt from dividend tax under that section. In both respects the decision below

is in conflict with controlling decisions of this Court.

(a) In so far as the decision below is predicated on the assumption that the issuance of the preferred stock must be divorced from the contemporaneous sale, it departs from the settled principle that the substance rather than the form of a transaction is determinative of its tax effect, and the corollary doctrine that literal compliance with a tax exemption provision does not necessarily suffice to bring a transaction within it. To permit the device here employed to insulate taxpayers from dividend tax would indeed sanction the kind of formalism which this Court has repeatedly condemned as ineffectual to escape or reduce tax liability. *Commissioner* v. *Court Holding Co.*, 324 U. S. 331; *Gregory* v. *Helvering*, 293 U. S. 465; *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609; *Bazley* v. *Commissioner*, 331 U. S. 737; *Griffiths* v. *Commissioner*, 308 U. S. 355; *Higgins* v. *Smith*, 308 U. S. 473; *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44.

In the *Court Holding* case, *supra*, a corporation distributed its property to its stockholders in the form of a tax-free liquidating dividend, and the stockholders in turn sold the property to a purchaser with whom prior negotiations had taken place, both steps being taken pursuant to a plan to reduce tax liability. This Court held that the Tax Court was fully warranted in viewing the entire transaction as if the property had been sold directly by the corporation to the purchaser, and

as if the corporation had received the cash price and had distributed it to the stockholders, notwithstanding that legal title to the property first passed to the stockholders who then made the sale in their own names. The Court stated that (p. 334)—

> the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

The Tax Court was here likewise justified in viewing the transaction "as a whole," and in concluding that the temporary passage of title to the preferred stock to the stockholders was but an intermediate formal step, designed to mask a taxable dividend distribution as a tax-free stock dividend and resale of the dividend stock.

In the *Minnesota Tea* case, *supra,* a corporation sought to come within a provision exempting from tax the gain upon a reorganization to the extent that cash received in the transaction was distributed to the stockholders. The cash was actually distributed by the corporation to its stockholders, but in accordance with a prior understanding the stockholders used it to pay debts of

the corporation. In oft-repeated language this Court stated (pp. 613-614):

> A given result at the end of a straight path is not made a different result because reached by following a devious path. The preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission of the fund to the creditors, all along intended to come to their hands, so transparently artificial that further discussion would be a needless waste of time. The relation of the stockholders to the matter was that of a mere conduit.

The end result of the various steps here employed—issuance of preferred stock to the taxpayers and retransfer of it to the previously selected purchasers—was no different than if the corporation had sold the stock directly to the purchasers and distributed the cash proceeds to the taxpayers. In the words of the *Minnesota Tea* case, "the preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission" of the stock to the purchasers, and "the relation of the stockholders to the matter was that of a mere conduit."

In the *Gregory* case, *supra*, a taxpayer desiring to withdraw securities from a wholly owned corporation without being taxed with the receipt of a dividend formed another corporation to which the securities were transferred, and the new corporation was then liquidated and the securities distributed to the taxpayer. There was no doubt

that, as a literal matter, these steps did not constitute a dividend distribution and that they did comply with the statutory terms describing a nontaxable reorganization. The Court nevertheless held that a taxable dividend was distributed by the original corporation to the taxpayer. Measuring "what actually occurred" against what "the statute intended", it stated that the arrangement was (p. 469)—

> Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.

To paraphrase the above language, the preliminary issuance of the preferred stock to the stockholders in the instant case was a mere device to conceal a sale of the stock by the corporation; the sole object and effect of the arrangement was the consummation of a preconceived plan, not to distribute the stock to the taxpayers as a stock dividend, but to sell it to third parties for cash and enable taxpayers to realize the cash benefits. While the taxpayer in *Gregory* attempted a plan which would give the appearance of a nontaxable "reorganization" and the taxpayer here attempted a plan which would give the appearance of a nontaxable stock dividend, the cases are parallel in that, when

the ultimate objective was accomplished, the stockholders in each had, though indirectly, managed to realize on the corporation's earnings while retaining their original stock interests.

The decision below is also in conflict with decisions of other Courts of Appeals which refuse to accord tax effect to step transactions designed to disguise a taxable event. *Meurer Steel Barrel Co.* v. *Commissioner,* 144 F. 2d 282 (C. A. 3d), certiorari denied, 324 U. S. 860; *Kaufmann* v. *Commissioner,* 175 F. 2d 28 (C. A. 3d); *Fairfield S. S. Corp.* v. *Commissioner,* 157 F. 2d 321 (C. A. 2d), certiorari denied, 329 U. S. 774; *Embry Realty Co.* v. *Glenn,* 116 F. 2d 682 (C. A. 6th); *Hellebush* v. *Commisisoner,* 65 F. 2d 902 (C. A. 6th); *Wichita Term. El. Co.* v. *Commissioner,* 162 F. 2d 513 (C. A. 10th).

(b) Even if it be assumed that the issuance of the preferred stock and the concurrent sale of it were independent transactions, it still would not follow, as the court below further assumed, that the stock dividend was not a taxable one under Section 115(f). That section exempts from the dividend tax only those stock dividends which do not constitute income within the meaning of the Sixteenth Amendment to the Constitution. In holding that the preferred stock which taxpayers here received as a dividend did not represent constitutionally taxable income, the court below has misconceived and consequently misapplied the decisions of this Court in cases dealing with the taxability of stock dividends. Nothing in the deci-

sions upon which the court below relied justifies the view that common stockholders do not realize taxable income where they receive preferred stock which for all practical purposes is the equivalent of cash, and in fact is converted into cash immediately upon its receipt. [8]

On this aspect of the case, the decision below conflicts in principle with *Bazley* v. *Commissioner*, 331 U. S. 737. See also *Adams* v. *Commissioner*, 331 U. S. 737. There the controlling stockholders of a corporation exchanged their stock for new stock and debentures of the corporation, and claimed that this constituted a "recapitalization" which qualified as a non-taxable reorganization within the meaning of Code Section 112(b) and (g). This Court agreed that what took place was a reorganization in the literal sense. However, it pointed out that Congress, in making such transactions non-taxable, was concerned with situations where the exchange of securities (p. 740) "represents merely a new form of the previous participation in an enterprise" and involves "no change of substance in the rights and relations of the interested parties one to another or to the corporate assets". Observing that (p. 743) "nothing was accomplished that would not have been accom-

[8] Thus in *Strassburger* v. *Commissioner*, 318 U.S. 604, which the court below apparently deemed controlling here, this Court noted (p. 607) that the taxpayer (the sole stockholder) "still holds the preferred stock", that he "owned exactly the same interest in the net value of the corporation as before", and that he "retained all the incidents of ownership he had enjoyed before". No such situation is here presented. See also *Koshland* v. *Helvering*, *supra*, and *Helvering* v. *Gowran*, *supra*.

plished by an outright debenture dividend", and that a reorganization "which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders" is not a non-taxable exchange, the Court held that the shareholders received a taxable dividend equal to the value of the debentures. The Court said (p. 742):

> In the case of a corporation which has undistributed earnings, the creation of new corporate obligations which are transferred to stockholders in relation to their former holdings, so as to produce, for all practical purposes, the same result as a distribution of cash earnings of equivalent value, cannot obtain tax immunity because cast in the form of a recapitalization-reorganization. * * *
>
> * * * The debentures were found to be worth at least their principal amount, and they were virtually cash because they were callable at the will of the corporation which in this case was the will of the taxpayer. * * *

The preferred stock which taxpayers here received was no less tantamount to a cash distribution of earnings than the debentures received by the taxpayers in the *Bazley* case. Under the rationale of the *Bazley* decision the instant case is indeed an *a fortiori* one for treating the securities received as a taxable dividend. Not only was the preferred stock redeemable at the will of the corporation (as were the debentures in *Bazley*), but it was subject to mandatory redemption within

seven and one-half years. (R. 55.) [4] Furthermore, the terms of the preferred stock were designed to meet the investment requirements of the purchaser-insurance companies, so as "to give the degree of protection usually found in a first lien bond issue". (R. 62, 71.) What is more, even prior to the declaration of the preferred stock dividend, taxpayers had arranged to transfer it to the purchasers for cash. That the stock was worth its face amount in cash is conclusively demonstrated by the fact that, contemporaneously with its receipt, it was exchanged for cash of an equivalent amount.

While in the *Bazley* case the debentures were issued to the common stockholders through the medium of a "recapitalization", and in this case preferred stock was issued by way of a "stock dividend", the underlying question is essentially the same and the reasoning in *Bazley* applies here with full force. Indeed, where the new securities consist of stock, the difference between a recapitalization and a stock dividend is purely one of form, the old stock certificates being surrendered in the former but not the latter transaction. The kind of stock dividend which Congress intended should be tax-free under Section 115(f), like the kind of recapitalization which the Court in *Bazley* held was intended to be tax-free under Section 112, is that which does not substantially alter the preexisting interests of the stockholders. Section 115(f) no more furnishes a vehicle for circumvent-

[4] The debentures in *Bazley* and *Adams* had a maturity of 10 and 20 years, respectively.

ing a dividend tax on what is essentially equivalent to a cash distribution of corporate earnings than does Section 112.

3. The decision below is also in conflict with rules governing the scope of appellate review of the trial court's factual determinations. *Commissioner* v. *Court Holding Co.*, 324 U. S. 331; *United States* v. *Cumberland Pub. Serv. Co.*, 338 U. S. 451; *Dobson* v. *Commissioner*, 320 U. S. 489; *Wilmington Co.* v. *Helvering*, 316 U. S. 164; *Commissioner* v. *Scottish American Co.*, 323 U. S. 119. "Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences." *Dobson* v. *Commissioner, supra*, p. 502. "It is for the trial court upon consideration of an entire transaction, to determine the factual category in which a particular transaction belongs". *United States* v. *Cumberland Pub. Serv. Co., supra*, p. 456. And the trial court's conclusion may not be disturbed unless it is "clearly erroneous". Rule 52(a), Federal Rules of Civil Procedure.

Although the court below recognized that (R. 102) "each case necessarily depends upon its own facts," it proceeded to substitute its own inferences for those of the Tax Court. Disregarding the circumstances which impelled the Tax Court to conclude that the stock dividend in question was neither a bona fide stock dividend nor a nontaxable one, it

treated the issuance of the stock and the concurrent sale of it as if they were two independent transactions, each falling in a separate tax compartment. In effect it held that the Tax Court was precluded by the form in which the transaction was cast from finding that the two events were connected links in a single chain, and was obliged as a matter of law to isolate one step from the other.[5]

4. The issue in this case is an important one in the interpretation and administration of the taxing statute, the answer to which will have a serious impact upon the revenues. It amounts to nothing less than whether the controlling stockholders of a corporation may insulate themselves from ordinary income tax liability on what is essentially a cash dividend distribution simply by creating the surface appearance of a non-taxable preferred stock dividend. During the past several years attempts to achieve such immunity have been unavailing.[6] The decision below if left unchallenged will

[5] In stressing (R. 99-102) that the preferred stock constituted real stock the court below addressed itself to a straw issue. The critical questions are (1) whether the stock was really issued to the taxpayers, or sold to the transferee-purchasers; and (2) even if regarded as having been issued to taxpayers, whether it was nevertheless the equivalent of a cash dividend.

[6] The Chief Counsel of the Internal Revenue Service has advised the Department of Justice that "the decision in the instant case undermines the accepted tax policy of the last five years, and will result in the development of many devices for the use of preferred stock bail-outs to the distortion of normal business transactions and to the detriment of sound tax administration." (Letter dated December 17, 1953, from Daniel A. Taylor to Assistant Attorney General H. Brian Holland). The writers who have considered the kind of situation presented by this case have hitherto agreed that the stockholders are taxable with the receipt of ordinary dividend income.

open a wide avenue of escape from the dividend tax, and will undoubtedly lend impetus to the adoption of similar tax avoidance schemes by stockholders of family corporations. Unless the question is authoritatively resolved by this Court, the decision below may be expected to furnish a prolific source of tax litigation in the future.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

ROBERT L. STERN,
Acting Solicitor General.

JANUARY, 1954.

DeWind, Preferred Stock "Bail-outs" and the Income Tax, 62 Harv. L. Rev. 1126 (1949); Platt, Preferred Stock Dividends and Recapitalizations after the Bazley and Adams cases, N.Y.U. Seventh Annual Institute on Federal Taxation 561 (1949); DeWind, Preferred Stock Dividends and Recapitalizations, N.Y.U. Eighth Annual Institute on Federal Taxation 236 (1950); Stockholder Realization of Corporate Earnings and the Income Tax, 17 U. Chi. L. Rev. 338, 351 (1950); and Darrell, Recent Developments in Nontaxable Reorganizations and Stock Dividends, 61 Harv. L. Rev. 958, 977 (1948).

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains,, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * * without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof,

and from the most recently accumulated earnings or profits. * * *

* * * * *

(f) *Stock Dividends.*—

(1) *General rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

(2) *Election of shareholders as to medium of payment.*—Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

* * * * *

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be

included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

* * * * *

(26 U.S.C. 1946 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.115-1. *Dividends.*—The term "dividend" for the purpose of chapter 1 * * * comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either—

(1) earnings or profits accumulated since February 28, 1913, or

(2) earnings or profits of the taxable year computed without regard to the amount of the earnings or profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

* * * * *

A taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands.

* * * * *

Sec. 29.115-7. *Stock Dividends.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock

shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the sixteenth amendment to the Constitution. * * *

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1953

No. 530

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

C. P. CHAMBERLIN[1]

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

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BRIEF FOR THE RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 51-73) is reported in 18 T. C. 164. The opinion of the Court of Appeals (R. 91-103) is reported in 207 F. 2d 462.

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[1] Together with *Commissioner of Internal Revenue, Petitioner* v. *Grace A. Chamberlin; Commissioner of Internal Revenue, Petitioner* v. *John H. Toner; Commissioner of Internal Revenue, Petitioner* v. *Benjamin James Carl; Commissioner of Internal Revenue, Petitioner* v. *Guy V. Schrock; Commissioner of Internal Revenue, Petitioner* v. *Robert Pierce and Josephine H. B. Pierce.*

JURISDICTION

The judgments of the Court of Appeals were entered on October 14, 1953. (R. 87-91.) The petition for writs of certiorari was filed on January 11, 1954. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

The stockholders of a corporation received a dividend of preferred stock on common stock, which was the only class of stock then outstanding. The receipt of the preferred shares did not in any way change the pre-existing proportionate interests of the stockholders. The question is whether the preferred stock was nevertheless a taxable dividend because the stockholders sold the stock shortly after its distribution.

STATUTES AND REGULATIONS INVOLVED

The relevant statutes and regulations appear in Appendix A, *infra*.

STATEMENT

The facts in the main are stipulated and they are not in dispute.[2] They may be summarized as follows:

In 1946 the taxpayers were stockholders in Metal Mouldings Corporation,[3] which makes metal mouldings and bright work trim used in the manufacture of automobiles. From 1940 until December 20, 1946, the issued and outstanding common stock totalled 1,002½ shares. C. P. Chamberlin and his wife, Grace, together owned 83.8 percent of the

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[2] The Commissioner erroneously argues that the Court of Appeals substituted its own "inferences of fact for those of the Tax Court." (Pet. 9.) See further p. 13, *infra*.

[3] Our references to the respondent taxpayers do not include Josephine H. B. Pierce, since she was not a stockholder in the corporation. The Commissioner has asserted a deficiency against her because she filed a joint return with her husband, Robert Pierce, for the taxable year in question. (R. 41, 56.)

stock. The business of the corporation prospered. Between 1937 and 1945 its net earnings, after taxes, were $2,751,913.07, and it paid substantial cash dividends aggregating $1,604,000. As of June 30, 1946, it had total assets of $2,488,836.53 and an earned surplus of $1,267,566.77. (R. 35, 52-54, 92.)

On December 16, 1946, the authorized capital stock of the corporation was increased from $150,000 to $650,000, represented by 6,500 shares of $100 par value common stock. On December 20, 1946, a stock dividend of common was declared and the corporation distributed five shares of common for each share of common outstanding, or a total of 5,012½ shares. The sum of $501,250 was accordingly transferred from earned surplus to capital account. (R. 54, 92.)

On December 26, 1946, the authorized capital of the corporation was increased to $1,452,000, represented by 8,020 shares of 4½ percent cumulative preferred stock, having a par value of $100, and 6,500 shares of common stock having the same par value. On December 28, 1946, a stock dividend of preferred was declared and the corporation distributed 1⅓ shares of preferred for each share of common outstanding, or a total of 8,020 shares. The sum of $802,000 was accordingly transferred from earned surplus to capital account. (R. 55-56, 92-93.)

Two days later the taxpayers, owning 8,000 of the preferred shares, agreed to sell 4,000 to the Lincoln National Life Insurance Company and 4,000 to the Northwestern Mutual Life Insurance Company. The purchase price was $100 per share, plus the amount of dividends accrued from November 1, 1946, to the date of delivery. On the same day the 8,000 shares were transferred to the insurance companies for $805,900. (R. 54-56, 58-60, 92-93.)

C. P. Chamberlin and the insurance companies engaged in negotiations before the distribution of the preferred stock. In entering into these negotiations Chamberlin was guided by a desire to save income taxes. The corpora-

tion had regularly made substantial distributions to the stockholders.[4] Chamberlin feared the tax consequences of any additional dividends because his income was already well into the highest bracket of 91 percent.[5] He was advised that the stockholders' tax burden would be less if the corporation distributed a dividend of preferred stock and the stockholders then sold the dividend shares to others. Both insurance companies made a detailed investigation of Metal Mouldings Corporation and carefully analyzed the terms of the proposed stock. No agreement of purchase was entered into until after the preferred shares were distributed to the taxpayers. (R. 53-54, 61-63, 93-95.)

The holders of the preferred shares were entitled to cumulative cash dividends in quarterly instalments beginning on November 1, 1946. The shares were subject to redemption on May 1, 1948, in an amount not exceeding 2,000 shares, and on May 1st of succeeding years in an amount not exceeding 1,000 shares. The precise amount to be redeemed depended upon the corporation's net earnings for the year preceding the redemption date. The corporation might, on any quarterly dividend date, redeem the preferred, in whole or in part, at par plus specified premiums and accrued dividends. If four quarterly dividends remained unpaid or if less than 500 shares were retired on each of any two annual retirement dates, the holders of the preferred were entitled to elect a majority of the directors. As long as any preferred shares were

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[4] In 1942 the dividends were more than twice the corporation's net profits after taxes. In 1943 through 1945 the dividends aggregated $400,000 out of net profits after taxes totalling $887,172.35. (R. 54.)

[5] Apart from the asserted deficiency, Chamberlin reported a net income of $572,467.57 for 1946. (R. 11.) The combined normal tax and surtax for that year reached a maximum of 91 percent on any net income beyond $200,000. The total tax computed under the general schedule of rates was subject to a reduction of 5 percent. Revenue Act of 1942, § 102, 56 Stat. 802, amending Int. Rev. Code § 11.

outstanding, the corporation's net working capital could not be reduced below 150 percent of the value of the outstanding preferred shares or $750,000, whichever was greater; and the current assets could not be reduced below 200 percent of current liabilities. The consent of stockholders owning 75 percent of the preferred shares was required in order to change the articles of incorporation, to revise the capital structure, to sell substantially all the property, or to incur additional indebtedness beyond a stated amount. (R. 55, 94.)

In his return for 1946 each taxpayer reported the proceeds from the sale of his preferred stock as a net long-term capital gain, after subtracting the cost of the sale and the basis of the stock. (R. 63.) The Commissioner determined that the preferred stock was a taxable dividend, and that the value of the preferred was taxable as ordinary income. He further determined that the value of the preferred was the amount received on the sale. (R. 63.)[6] The Tax Court sustained the Commissioner's determination. (R. 64-73.) One judge concurred in the result in a separate opinion (R. 73-75); another judge concurred in the result without opinion (R. 73); and a third judge dissented (R. 75-78). The Court of Appeals unanimously reversed. (R. 91-103.)

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[6] The Commissioner now says that he determined "that the amount received by each taxpayer constituted a dividend taxable as ordinary income." (Pet. 8.) But as both opinions below clearly indicate, the Commissioner actually determined that the preferred stock itself was a taxable dividend. In his notice of deficiency the Commissioner advised the taxpayers that it is the "value" of the preferred stock "received" from the corporation which "is taxable to you as a dividend." This was the very conclusion which the Tax Court also reached. (R. 52, 63, 64, 73.) Otherwise, the Tax Court would not have spent so much time on the proportionate interest rule relating to stock dividends. (R. 64-73.) See further p. 9, *infra*.

ARGUMENT

We respectfully submit that the decision of the Court of Appeals is clearly correct and does not present any special and important reason for a grant of certiorari. The decision rests securely on the statutes enacted by Congress and the decisions rendered by this Court. Indeed, the Commissioner is simply attempting to pry open a question which has long been closed.

1. Section 115(a) of the Internal Revenue Code provides that a dividend is "any distribution made by a corporation to its shareholders, whether in money or in other property," out of its earnings or profits after February 28, 1913. This general rule is qualified by a specific rule for stock dividends. Section 115(f)(1) states that a "distribution made by a corporation to its shareholders in its stock" is not to "be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution." The Treasury regulations add that the term "dividend" under Section 115(a) "does not include distributions" under Section 115(f), "relating to stock dividends." Regulations 111, § 29.115-1.

This Court has determined that certain stock dividends are not "income to the shareholder within the meaning of the Sixteenth Amendment." In *Eisner* v. *Macomber*, 252 U. S. 189 (1920), and *Helvering* v. *Griffiths*, 318 U. S. 371 (1943), the Court held that a dividend of common stock on common stock is not taxable income. In *Strassburger* v. *Commissioner*, 318 U. S. 604 (1943), the Court further held that a dividend of preferred stock on common stock, where only common stock is outstanding, is similarly not taxable. At the same time the Court ruled in *Helvering* v. *Sprouse*, 318 U. S. 604 (1943), that a dividend of non-voting common on voting common and non-voting common is also tax-free. All these decisions derive from the basic principle that a stock dividend is not taxable "within

the meaning of the Sixteenth Amendment" unless the distribution of the dividend alters the pre-existing proportionate interest of the stockholder. See further *Koshland* v. *Helvering*, 298 U. S. 441 (1936); *Helvering* v. *Gowran*, 302 U. S. 238 (1937). It is also settled that if dividend shares are non-taxable distributions, the stockholder does not realize any taxable gain until he sells the shares. See *Eisner* v. *Macomber, supra*, at 212; *Helvering* v. *Griffiths, supra*, at 375. The profit derived on a sale of the dividend shares is then taxable "as a gain derived through sale of some of the original shares would be." *Miles* v. *Safe Deposit Co.*, 259 U. S. 247, 253 (1922).

Congress has enacted and the Treasury has promulgated special provisions which govern the sale of dividend shares received in a non-taxable distribution. Section 113(a)(19)(A) declares that if a shareholder receives a stock dividend which is not taxable, "the basis of the new stock and of the old stock, respectively, shall, in the shareholder's hands, be determined by allocating between the old stock and the new stock the adjusted basis of the old stock." The regulations meticulously indicate the method of allocation. They state that the basis is to be apportioned whether or not the stock dividend is "of a character or preference materially different from the stock in respect of which the distribution is made." Regulations 111, § 29.113(a)(19)-1, as correlated with § 29.113(a)(12)-1.

Section 117(h)(5) of the Code provides that if the basis of the dividend stock is determined under Section 113(a)(19)(A), "the period for which the taxpayer has held" the dividend stock includes "the period for which he held the stock in the distributing corporation" before the receipt of the dividend stock. Or, as the regulations express the same thought, "The period for which the taxpayer has held stock . . . issued to him as a dividend shall be determined as though the stock dividend . . . were the stock in respect of which the dividend was issued if the basis for determining gain or loss upon the sale or other

disposition of such stock dividend . . . is fixed by the apportionment of the basis of such old stock." Regulations 111, § 29.117-4. Finally, under Section 117(a) and (c) a gain realized on the sale of a capital asset held for more than six months is taxable as a long-term capital gain.

Each taxpayer correctly computed his taxes in the light of the statutes, regulations and cases. Since only common stock was outstanding when he received the preferred, the preferred was not a taxable dividend "within the meaning of the Sixteenth Amendment." *Strassburger* v. *Commissioner, supra.* See also *Stern* v. *Commissioner,* 32 A.F.T.R. 1737 (7th Cir. 1943), *rev'g* 46 B.T.A. 416 (1942); *Charles M. Cooke, Ltd.,* 2 T. C. 147 (1943). Cf. *Estate of Joseph E. Sorg,* 1 T.C.M. 879 (1943). Therefore, under Section 113(a)(19)(A) a portion of his basis for his common stock was allocable to his preferred stock; and under Section 117(h)(5) the holding period of his preferred stock included the holding period of his common stock. And so the Court of Appeals quite properly held that the sale of the preferred stock was a sale of a capital asset held for more than six months, and that the resulting profit was a long-term capital gain.

Again, the Court of Appeals correctly held that the desire to save taxes did not affect the conclusion. In the words of Judge Learned Hand, "a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it." Where "the transaction under scrutiny is in fact what it appears to be in form," it is immaterial whether the taxpayer sought "to avoid taxes, or to regenerate the world." *Chisholm* v. *Commissioner,* 79 F. 2d 14, 15 (2d Cir. 1935), *cert. denied,* 296 U. S. 641 (1935). It is the statute which counts. See *Commissioner* v. *Korell,* 339 U. S. 619 (1950). To borrow a felicitous phrase of Mr. Justice Holmes, "the standards of the law are external standards" (Holmes, The Common Law 110 (1881)), unless the statute itself indicates that "purpose or state of mind determines the incidence" of the tax.

See *Helvering* v. *National Grocery Co.*, 304 U. S. 282, 289 (1938). Here no such subjective statute intrudes upon the controversy. The Commissioner has unintentionally illustrated what Judge Magruder has recently noted. While a desire to save taxes is not "rightly" significant, "it sometimes is permitted to give a spurious flavor" to an argument. *Channing* v. *Hassett*, 200 F. 2d 514, 516 (1st Cir. 1952).

2. The Commissioner evidently concedes that each taxpayer received a dividend of preferred stock; that he then contracted to sell the stock to the insurance companies; that he sold the stock in accordance with his agreement; and that the cash which he received was paid by the insurance companies. (Pet. 2, 6, 13.)[7] Cf. *United States* v. *Cumberland Public Service Co.*, 338 U. S. 451 (1950). The Commissioner also concedes that a stock dividend is not taxable unless its receipt alters the stockholder's proportionate interest in the corporation. (Pet. 22.) In the Commissioner's own words, "whether such a dividend constitutes taxable income depends on whether it produces a change in the pre-existing proportionate interests of the stockholders." (Pet. 11.) And at no point does the Commissioner suggest that the taxpayers' receipt of the preferred shares changed their relative interests. Hence the Commissioner's quarrel with the Court of Appeals turns solely and precariously on a novel argument. He contends that a stock dividend which is otherwise nontaxable becomes taxable if the stockholder sells the dividend shares shortly after he receives them.[8] To summarize the

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[7] The Commissioner's own witnesses testified that there was no agreement to sell the dividend stock until after its distribution. (R. 26, 28.)

[8] The Tax Court relied heavily on the equally novel argument that the stockholders' proportionate interests were altered by the eventual sale of the dividend shares. (R. 70-72.) The Court of Appeals easily disposed of this argument (R. 97), and the Commissioner has not revived it in his petition.

Commissioner's extraordinary position, the dividend shares would not have been taxable if they had not been sold, but they are taxable because they were sold.[9]

The Court of Appeals rejected this singular argument. "A non-taxable stock dividend," said the Court, "does not become a taxable cash dividend upon its sale by the recipient. On the contrary, it is a sale of a capital asset .... Obviously, if the non-taxability of a stock dividend rests solely upon the principle that it does not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of any of his holdings, the disposition of the stock dividend by the stockholder thereafter is not a factor in the determination." (R. 99.) Moreover, the Court added, the stock dividend cannot be taxed as if cash came from the corporation rather than the purchasers. The money received by each stockholder "was received from the insurance companies. It was not a 'distribution' by the corporation declaring the dividend, as required by the statute." (R. 100.)

This conclusion seems eminently correct. A distribution by a corporation consists of what the stockholder receives from the corporation. Section 115 of the Code plainly provides that a dividend is at the very least a "*distribution made by a corporation* to its shareholders."[10] See *Estate of Putnam* v. *Commissioner*, 324 U. S. 393, 399, 400 (1945);

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[9] The Commissioner dwells at some length on the sales negotiations between Chamberlin and the insurance companies before the preferred stock was distributed to the taxpayers. However, we doubt whether the Commissioner regards the negotiations—apart from the sale itself—as adding much to his argument. If the issuance of a stock dividend does not alter the proportionate interest of a shareholder, his state of mind has no greater impact. Intention alone does nothing and changes nothing. Certainly the Commissioner is not saying that a sale of dividend shares has varying consequences, depending on whether the negotiations precede or follow the distribution of the shares. In both cases the results are precisely the same.

[10] Italics supplied.

Commissioner v. *Munter*, 331 U. S. 210, 214 (1947); *Commissioner* v. *Phipps*, 336 U. S. 410, 416, 419 (1949). "A stockholder does not pay for accumulated profits of his corporation unless he receives a dividend" (*Weiss* v. *Wiener*, 279 U. S. 333, 335 (1929)), and a "taxable dividend" is a "taxable corporate distribution." *Choate* v. *Commissioner*, 129 F. 2d 684, 687 (2d Cir. 1942). Or, as Mr. Justice Stone succinctly stated, "The distribution contemplated and defined" by Section 115 "as a dividend is one to be effected by corporate action." *Palmer* v. *Commissioner*, 302 U. S. 63, 71-72 (1937). By the same token, a distribution of stock by a corporation is something quite different from a sale of the stock by a shareholder. See *Eisner* v. *Macomber*, *supra*, at 212; *Helvering* v. *Griffiths*, *supra*, at 375. It is hornbook law that the proceeds realized by a shareholder on the sale of his stock are not a distribution from the corporation, whether the stock be original shares or dividend shares. See, for example, *Chapman* v. *United States*, 63 Ct. Cls. 106 (1927), *cert. denied*, 275 U. S. 524 (1927); *Insull* v. *Commissioner*, 87 F. 2d 648 (7th Cir. 1937); *Silas H. Burnham*, 29 B.T.A. 605 (1933); *Dodd, Mead & Co.*, 43 B.T.A. 739 (1941), *aff'd*, 123 F. 2d 145 (2d Cir. 1941); *Stanley D. Beard*, 4 T.C. 756 (1945); *Rodman Wanamaker Trust*, 11 T.C. 365 (1948), *aff'd*, 178 F. 2d 10 (3d Cir. 1949). Judge Arundell has concisely summarized the cases. A distribution consists of "what a stockholder receives from his corporation"—not what he may later receive from others. (R. 75.) The cases merely say what the Treasury itself has said. "Income resulting from the sale of stock received as a stock dividend is not the receipt of a dividend but gain or profit derived from the sale of stock." T.D. 4027, VI-1 Cum. Bull. 164 (1927). To the same effect see also G.C.M. 8751, X-1 Cum. Bull. 219 (1931).

It is equally settled that an early sale of dividend shares has no bearing on their taxability. *Insull* v. *Commissioner*,

supra; Silas H. Burnham, supra.[11] Cf. *Daisy M. Ward*, 29 B.T.A. 1251, 1254 (1934), *petition dismissed*, 79 F. 2d 381 (8th Cir. 1935); G.C.M. 8751, *supra*. As the Court of Appeals indicated, Congress has not drawn any distinction between a sale which quickly follows a distribution and a sale which is long delayed. Precisely the reverse is true. Congress has affirmatively declared that no such distinction is to be made. Section 117(h)(5) provides that if a shareholder receives a tax-free stock dividend, the holding period of the old shares is tacked on to the holding period of the new shares. This statute can only apply if the dividend stock is sold within six months after its receipt. Otherwise it serves no function at all.

If stock is held for more than six months, a profit realized on its sale is taxable as a long-term capital gain. If stock is held for a shorter period, a profit realized on its sale is taxable as ordinary income. Int. Rev. Code § 117(a)(b)(c). Obviously, if a shareholder receives a stock dividend which leaves his proportionate interest unchanged and holds the new stock beyond six months, he is entitled to capital gain treatment without the aid of Section 117(h)(5). The sole purpose of that provision is to tack on the holding period of the old shares where the new shares are sold within six months after they are received by the stockholder. The statute necessarily contemplates that a tax-free distribution of stock will often be followed by a quick disposition. Or to restate the same

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[11] The Commissioner's position is particularly puzzling in the light of the *Burnham* decision. Since 1934 he has formally accepted that case as expressing the correct rule where stock dividends are expeditiously sold. XIII-1 Cum. Bull. 3 (1934). In the *Burnham* case the shareholders contracted to sell the dividend shares before they were received and they were sold on the same day that they were received. The Tax Court held that the stock dividend was non-taxable, and that the sale of the dividend shares in accordance with the prior contractual commitment was not a distribution of cash by the corporation. In the present case the stockholders did not enter into any agreement of purchase and sale until after the stock dividend was distributed.

assumption, Section 117(h)(5) presupposes that a distribution of stock does not become taxable merely because the shareholder is able to make an early sale.[12]

It is not difficult to isolate the source of the Commissioner's error. He is disturbed that a sale of non-taxable dividend shares enables a stockholder to pay a capital gains tax on proceeds which represent the stockholder's interest in accumulated earnings of the corporation. But any sale of stock in a prosperous corporation has the same effect, whether the stock consists of original shares or dividend shares, and whether the stock is sold sooner or later. These consequences inhere in the nature of stock as a financial symbol representing an aliquot interest in corporate capital and surplus. And whenever a corporation distributes a tax-free stock dividend, the equity reflected by the dividend may be realized through a sale, whether the stock is publicly held or closely held, and whether the stock is common or preferred.[13]

3. The Commissioner complains that the Court of Appeals substituted its own inferences of fact for those of the Tax Court. According to the Commissioner, the Tax Court found that the issuance of the preferred stock and

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[12] Section 115(f)(2) of the Code is additionally illuminating here. This provision states that a stock dividend is not exempt from tax if the corporation also gave the stockholders an option to receive cash. Here, too, the emphasis is clearly on the cash which *the distributing corporation* makes available to its stockholders. Otherwise the status of non-taxability remains unimpaired. In *Eisner* v. *Macomber*, *supra*, at 211, 215, the Court pointed out that it was considering only *bona fide* or true stock dividends, as distinguished from optional stock dividends. In his dissenting opinion Mr. Justice Brandeis argued that both kinds should be treated alike. 252 U. S. at 220 *et seq.* But he did not remotely suggest the strange argument that proceeds derived on a sale of dividend shares may be taxed as a distribution by the corporation. At the very beginning of his opinion Mr. Justice Brandeis distinguished between the receipt of a stock dividend and a sale of "the new stock received as a dividend." *Id.* at 220. To him a dividend was something "received by a stockholder from a corporation." *Id.* at 226, 237.

[13] See also p. 24, *infra*.

the sale to the insurance companies were "interrelated component steps in a single prearranged transaction." On the other hand, the Court of Appeals allegedly "treated the issuance of the stock and the concurrent sale of it as if they were two independent transactions, each falling in a separate tax compartment." (Pet. 9-10, 23-24.) The Commissioner, we believe, has discovered a difficulty where none exists.

We readily agree, as the Tax Court held, that the receipt and sale of the dividend shares were not unrelated events, nor did the Court of Appeals in the least hold otherwise. The Court of Appeals specifically stated that the facts "are not in dispute" and it expressly accepted them as the Tax Court found them. (R. 92.) However, the Court concluded, as a matter of law, that an otherwise tax-exempt stock dividend does not become taxable merely because its receipt is quickly followed by a sale. (R. 97.)[14] This determination fell well within the province of the Court of Appeals—unless the Tax Court is to have the final say on the taxability of a stock dividend and the proceeds of its later sale. In short, the conclusion on appeal clearly derived from different "criteria for judgment" applied to the same "uncontroverted happenings." *Watts* v. *Indiana*, 338 U. S. 49, 51 (1949). The Tax Court relied on an erroneous standard of liability and, needless to add, its decisions are not binding where "the wrong standards for judgment have been applied." *Commissioner* v. *Culbertson*, 337 U. S. 733, 749 (1949). See also *Powers* v. *Commissioner*, 312 U. S. 259 (1941); *National Carbide Corp.* v. *Commissioner*, 336 U. S. 422 (1949); *Lilly* v. *Commissioner*, 343 U. S. 90 (1952). No one disputes that the terms of the preferred stock and the circumstances of its issuance were matters to be ascertained by the Tax Court. But it is equally true that the taxability of the dividend was "open

[14] As we have noted, the Tax Court held that the dividend shares themselves—and not the sales proceeds—were taxable as corporate distributions to the stockholders. See note 6, *supra*.

for determination" in the Court of Appeals, "unfettered by findings and rulings below except for the weight of the intrinsic authority of all lower court opinions." Frankfurter, J., in *Deputy* v. *du Pont*, 308 U. S. 488, 499 (1940). If the taxpayers had prevailed in the Tax Court, the Commissioner would hardly have urged that its decision was a mere inference of fact under Rule 52(a). We fail to see why his view should be different because he initially prevailed in the Tax Court and then lost on appeal. Whether a question is one of law or fact does not turn on whose foot is momentarily pinched.

4. In order to provide a basis for certiorari the Commissioner charges that the Court of Appeals failed to apply "the established principle that the substance rather than the form of a transaction is determinative of its tax effect." (Pet. 9.) This grievance cogently reveals the difficulties which the Commissioner has experienced in justifying his application to this Court.

As Judge Learned Hand has acutely noted, "such vague alternatives as 'form' and 'substance'" are "anodynes for the pains of reasoning." *Commissioner* v. *Sansome*, 60 F. 2d 931, 933 (2d Cir. 1932), *cert. denied*, 287 U. S. 667 (1932). They merely leave us on the threshold of the problem to be solved. Compare *United States* v. *Cumberland Public Service Co.*, *supra*, with *Commissioner* v. *Court Holding Co.*, 324 U. S. 331 (1945). The obligations of a taxpayer stem from the particular words used by Congress and not from some general homily available for all occasions. Taxation is a statutory subject, and any tax "asserted by the Commissioner" must be "authorized by Congress." *Helvering* v. *Griffiths*, *supra*, at 394.[15] Moreover, in tax cases, too, the meaning of a statute is not to be casually captured by some "seductive *cliché*." Cf.

[15] In any event, the Court of Appeals fully explored the Commissioner's argument in regard to "form" and "substance." No point which is now made was left untouched. (R. 98-102.)

Graves v. *N. Y. ex rel. O'Keefe*, 306 U. S. 466, 489 (1939). What we have just said is nicely illustrated by the Commissioner's argument. In the name of "substance" he has devoted a number of pages to various cases which have nothing to do with the statutes governing the taxability of stock dividends. Certainly, words and phrases on "form" and "substance," carefully culled from other areas of tax law, do not remotely indicate that the Court of Appeals' decision is "in conflict with applicable decisions of this court." Rule 38(5)(b) of Supreme Court Rules.[16]

The Commissioner's reference to *Bazley* v. *Commissioner*, 331 U. S. 737 (1947),[17] illustrates how far afield he has gone in seeking some ground for certiorari. The *Bazley* decision involved two closely held corporations. In both cases the stockholders exchanged their common stock, having a par value of $100, for new no-par common stock and debentures. The Commissioner taxed the debentures as a dividend. On the other hand, the taxpayers contended that the debentures had been received in a tax-free recapitalization under Section 112(g)(1)(E). This Court sustained the Commissioner.[18] It held that if each corporation had issued the debentures without a recapitalization, they would have constituted a taxable dividend. In the Court's view the result remained the same though there was also "an unrelated modification of the capital account." *Id.* at 742. It concluded that "nothing was accomplished that would not have been accomplished by an outright debenture dividend." *Id.* at 743.

The *Bazley* case is quite removed from the present context. There the only dispute was whether the stockholders

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[16] Only recently, during this Term, the Court denied certiorari where the Commissioner similarly invoked the same generalizations about "form" and "substance" as a basis for the writ. Petition for a Writ of Certiorari, pp. 14-16, *United States* v. *Arcade Company*, 346 U. S. 828 (1953).

[17] Pet. 20.

[18] Mr. Justice Douglas and Mr. Justice Burton dissented.

had received a dividend. If the answer was yes, the dividend was plainly taxable because it consisted of debentures taxable as a distribution in kind. Int. Rev. Code, § 115(j); Reg. 111, § 29.115-10; *Doerschuck* v. *United States*, 274 Fed. 739 (E.D.N.Y. 1921). The stockholders' liabilities were simply appraised in terms of what they received from the corporation. Here, however, there is no dispute that each taxpayer received a dividend. The question, rather, is whether the receipt of the dividend altered his relative equity in the corporation under the controlling principle of proportionate interest. And in an effort to tax the receipt of the preferred stock, the Commissioner is erroneously attempting to appraise his liability in terms of what he later obtained from others than the corporation. But the application of the principle of proportionate interest turns on what the stockholder received from the corporation.[19] Under that principle the only relevant question is whether the corporate distribution of the stock dividend changed the shareholder's interest in relation to the other shareholders. If the answer is no, the special rules on basis and holding period apply to the sale of the dividend shares.[20]

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[19] See p. 10, *supra*. The Commissioner somewhat emphasizes that the stock dividends had cash value upon issuance. He seems unaware that very few tax-free stock dividends, if any, ever lack cash value. If the Commissioner's view is well taken, he should also have taxed the common stock dividends which preceded the distribution of the preferred.

[20] The Commissioner's reference to *Gregory* v. *Helvering*, 293 U. S. 465 (1935), again illustrates how far off he is from the beaten track of this case. There the taxpayer effected a transfer of property to a corporation which was not intended to function or to obtain true rights in the property. The whole purpose "was merely to draught the papers." *Chisholm* v. *Commissioner*, *supra*, at 15. Here, on the other hand, the taxpayers transferred stock to independent buyers in an arm's length deal and the stock was undeniably a true equity. The reality of a corporate security is easily indicated by the "demonstrated possibility of sales" to "persons other than the stockholders." Cf. *John Kelley Co.* v. *Commissioner*, 326 U. S. 521, 525-526 (1946).

5. The Commissioner repeatedly insists that since the preferred stock was quickly sold after it was received, he may tax the distribution of the stock *as if* the stockholders had received cash from the corporation. In other words, he assumes that he may revise legal transactions because one follows the other in relatively rapid succession. But in the absence of a special dispensation the Commissioner is no less restrained than taxpayers in conjuring tax consequences out of imaginary transactions. For as Mr. Justice Brandeis pointed out, tax cases are not decided in response to transactions which never occurred. See *Founders General Co.* v. *Hoey*, 300 U. S. 268, 275 (1937). The decisions of this Court leave little to be said on the Commissioner's philosophy of "as if."[21]

In *General Utilities Co.* v. *Helvering*, 296 U. S. 200 (1935), a corporation owned securities which had appreciated in value. A prospective buyer desired to acquire them. The corporation indicated that the securities could be bought only after distribution to its stockholders, "since a sale by it would subject the realized profit to taxation, and when the proceeds passed to the stockholders there would be further exaction." 296 U. S. at 202. After the terms of sale were fairly clear, most of the securities were distributed as a dividend in kind to the stockholders, who then entered into a written agreement to sell them. The Government asserted a deficiency against the corporation, and argued, among other things, that the transfer to the stockholders should be ignored. According

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[21] We need not speculate as to the reactions of the Commissioner if a taxpayer boldly declared that he should be taxed on the basis of facts which failed to occur. The answer would then be—and properly so— that his liability must be determined on the basis of what was done and not what might have been done. Any attempt to apply a philosophy of "as if" would be criticized and deplored. See, e.g., *Founders General Co.* v. *Hoey, supra; Jeffries* v. *Commissioner*, 158 F. 2d 225 (5th Cir. 1946), *cert. denied*, 330 U. S. 843 (1947); *Wall* v. *United States*, 164 F. 2d 462 (4th Cir. 1947); *Estate of Elise W. Hill*, 10 T. C. 1090 (1948).

to the Government, the sale was made "in substance" by the corporation, "through the stockholders as agents or conduits through whom the transfer of the title was effected. The stockholders, even in their character as agents, had little or no option in the matter and in no sense exercised any independent judgment."[22] This Court held that the record afforded "no support whatever" for the attempt to treat the corporation as the seller.[23] "To remand the cause for further findings would be futile. The Board could not properly find anything which would assist the Commissioner's cause." *Id.* at 207.[24]

In *Helvering* v. *Tex-Penn Co.*, 300 U. S. 481 (1937), this Court again dealt with the tax incidence of successive transactions. The case involved five stockholders, an old corporation and a new corporation. Two of the stockholders planned to continue operations in the new corporation and the other three planned to retire. In accordance with their joint understanding, the three assigned their stock to the remaining two; the old corporation assigned its assets to the new corporation; the

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[22] This language is taken from the opinion of the Fourth Circuit, which sustained the Government. *Id.* at 205-206.

[23] The Court also held that the argument had been improperly raised.

[24] Cf. *Chisholm* v. *Commissioner*, *supra*, where two brothers transferred property to a newly formed partnership, which promptly sold the property as the brothers might have sold it. The Government argued that the first transfer should be disregarded, and that the sale should be taxed as if the brothers had sold the property and then contributed the proceeds to the partnership. The Second Circuit disagreed in an opinion written by Judge Learned Hand. In his discussion he carefully explained that the determinative element in the *General Utilities* case was whether the shareholders "were under legal liability to complete" a bargain made by the corporation. For "if they were free to choose whether or not to perform the company's contract, the company had not sold." 79 F. 2d at 16. The Second Circuit's analysis preceded and anticipated this Court's decision in the *General Utilities* case, which reversed the Fourth Circuit. See further the cogent summary in *Starr* v. *Commissioner*, 82 F. 2d 964 (4th Cir. 1936), *cert. denied*, 298 U. S. 680 (1936).

five stockholders assigned their individual properties to the new corporation; and the old corporation dissolved. In assigning their stock the retiring stockholders stipulated for a return of their shares if the transfer of assets to the new corporation failed to materialize. The question was whether the transfer from the old corporation to the new corporation was a tax-free reorganization under the Revenue Act of 1918. The Commissioner sought to resolve this question in the negative. He argued, among other things, that the old stockholders had in effect sold their stock to the new corporation for cash. In support of this view the Commissioner maintained that the prior assignment of the stock to the remaining stockholders "constituted a single indivisible transaction." *Id.* at 496. The Court held that the facts were otherwise and that the Commissioner could not rearrange the terms of the transactions to suit himself. The stipulation for a return of the stock "did not make the two sales a single or indivisible transaction." Even if the three stockholders "would not have sold their Tex-Penn stock without also selling" their individual properties, "that fact would not convert the two sales into one." *Ibid.*

The Court made the same point once more in *United States* v. *Cumberland Public Service Co., supra.* There the stockholders of the taxpayer wished to dispose of its assets at the least cost in tax. A prospective buyer offered to acquire the assets from the taxpayer. The offer was rejected because the taxpayer "would have been compelled to pay a heavy capital gains tax." In order to avoid this burden the stockholders offered to sell the assets after liquidating the taxpayer. The buyer agreed; the taxpayer was liquidated; and the stockholders transferred the distributed assets in accordance with "the previously contemplated sale." 338 U. S. at 452-453. The Government contended that the corporation had really made the sale, but its argument easily failed. The Court held, in an opinion by Mr. Justice Black, that the stockholders were

the sellers and that the reality of their transaction was unimpaired by "a major motive" to reduce taxes. The Government could not reconstruct the transaction because the liquidation before the sale failed to serve any business purpose. Under the statute "a corporation is taxed if it sells all its physical properties and distributes the cash proceeds as liquidating dividends, yet is not taxed if that property is distributed in kind and is then sold by the shareholders." The only significant question is whether the corporation or its shareholders have made the sale. True, "in both instances the interest of the shareholders in the business has been transferred to the purchaser." But the diversities in incidence are "inherent in the present tax pattern," and the pattern cannot be ignored because the taxpayers are aware of the diversities. *Id.* at 455-456. See also *Steubenville Bridge Co.*, 11 T.C. 789, 798 (1948).

These and many other cases[25] are variations on a common theme. The Commissioner cannot change transactions in order to achieve desired tax consequences. The same prohibition equally applies though one transaction rapidly follows another and the ultimate effect would have been identical if the taxpayer had consummated a different series of transactions. Obviously, in the *General Utilities, Tex-Penn*, and *Cumberland* cases the final result would have been no different if the taxpayers had planned their transactions to suit the preferences of the Commissioner. As the Tax Court has stated, it is beyond argument "that tax consequences are frequently very different under one state of facts from what they are under another state of facts." *Estate of Emanuel Ulman*, 46 B.T.A. 517, 526 (1942), *aff'd sub nom Citizens & Southern Nat. Bank* v. *Commissioner*, 136 F. 2d 406 (5th Cir. 1943), *cert. denied*, 320 U. S. 752 (1943). See also *Woodruff* v. *Commissioner*, 131 F. 2d 429 (5th Cir. 1942). A taxpayer is not morally obliged to choose

[25] See, e.g., *United States* v. *Cummins Distilleries Corp.*, 166 F. 2d 17 (6th Cir. 1948); *Chisholm* v. *Commissioner*, *supra*.

the course which the Commissioner would be inclined to favor. *Commissioner* v. *Gilmore's Estate*, 130 F. 2d 791, 795 (3d Cir. 1942).

For that matter, in the present case the Commissioner has done little more than re-argue the *Cumberland* case. His brief here largely echoes his brief there. In that case he methodically described the liquidation "as a form to cloak a sale of the corporation's property," and as "a meaningless step whereby there was a circuitous routing of title to the ultimate purchaser, the stockholders acting as pure conduits." Brief for the United States, p. 9, in *United States* v. *Cumberland Public Service Co., supra.* See also *id.* at 10, 13. "The liquidation distribution" was supposedly "only a step in an integrated plan to accomplish, somewhat deviously, the desired end, namely, the transfer to the intended purchaser. It was a meaningless gesture, except as it sought to achieve a different tax result and to place a different complexion on what would have been the situation if the passage of title had taken a less circuitous route from the corporation to the purchaser." *Id.* at 17-18. There also the Commissioner insisted that it was immaterial who negotiated and made the sale. *Id.* at 26. And he similarly cited and quoted the opinions in *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609 (1938),[26] and *Commissioner*

[26] In *Minnesota Tea Co.* v. *Helvering, supra*, the taxpayer assigned its assets to another company in exchange for the latter's stock and cash. The taxpayer transferred the cash to its stockholders, who assumed the obligation to pay its debts and then paid them. Under the governing statute a corporation was not taxable on any gain attributable to cash received in a reorganization if the cash was "distributed" to its stockholders. The Court held that the cash used to pay the taxpayer's debts was not "distributed" to the stockholders within the meaning of the statute. They received that amount, "not as a distribution for their benefit but as a fund the equivalent of which they were bound to pass on, and did pass on, to the creditors." *Id.* at 613. The Court simply applied the statute in the light of the substantive obligations actually created by the parties. There was no attempt to determine the tax consequences on the basis of some hypothetical or reconstructed transaction.

v. *Court Holding Co., supra.*[27]

Yet the Commissioner is not afraid to be inconsistent. He reasons quite differently where a cash dividend is followed, pursuant to an overall plan, by the stockholder's acquisition of additional stock. Then the Commissioner correctly contends that the corporation has made a taxable distribution of cash, regardless of the quick purchase of stock which produces an effect akin to a non-taxable distribution of stock. According to the Commissioner, "It is the inherent nature of the dividend itself that controls." *Lonsdale* v. *Commissioner*, 32 F. 2d 537, 539 (8th Cir. 1929), *cert. denied*, 280 U. S. 575 (1929). See also *Mrs. Frank Andrews*, 26 B.T.A. 642 (1932). The Court of Appeals properly concluded that the same view applies to stock dividends. This conclusion is easily supported by the facts here, for the Tax Court found that each taxpayer received preferred stock and then sold it as his own. As the Second Circuit declared in a cognate situation, "whether the transaction is viewed as a whole or as a series of separate steps," he fully enjoyed "freedom of action after he acquired the stock." "It is immaterial how soon thereafter he elects to dispose of his stock by gift or otherwise," though his election conforms to "a preconceived plan." *Wilgard Realty Co.* v. *Commissioner*, 127 F. 2d 514, 516 (2d Cir. 1942).

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[27] The Commissioner quotes a portion of the *Court Holding* opinion which involved a different problem relating to findings of fact where diverse inferences are permissible. (Pet. 16.) The language in question was addressed to the point that "in resolving such questions as who made a sale, fact-finding tribunals in tax cases can consider motives, intent, and conduct in addition to what appears in written instruments used by parties to control rights as among themselves." But once the content of a transaction is determined, motive is immaterial in determining the legal consequences which attach to that content. See *United States* v. *Cumberland Public Service Co., supra*, at 454-455. In the present case the triers of the facts have determined that the taxpayers received a pro rata dividend of preferred shares and then transferred them to the insurance companies. The only question in the Court of Appeals was whether the Tax Court had applied correct principles of law. See p. 13, *supra*.

6. The Commissioner's argument is no less than a disguised attempt to ignore this Court's decision in *Helvering* v. *Sprouse, supra,* and *Strassburger* v. *Commissioner, supra.* In attempting to prevail in those cases, the Commissioner maintained that the stock dividends were taxable because they could be sold for cash. In the *Sprouse* case the Government argued: "Prior to the receipt of the stock dividend the respondent owned only voting stock, but the distribution of the stock dividend constituted a readjustment of the corporate structure such that he could sell his non-voting stock and still retain the same control over the enterprise. This new stock represented corporate earnings convertible into cash by sale without diminishing the respondent's basic interest any more than would have been the situation in the *Koshland* case had the stockholder there sold the stock dividend." Brief for the Petitioner, pp. 5-6. In the *Strassburger* case the argument was the same. The "important fact," said the Government, "is that the distribution of a new kind of stock gives the recipient rights which are of a different character from those which he previously owned." "Since the new stock carries no voting rights it might be disposed of without affecting petitioner's control of the corporation. It carries with it the right to the payment of a fixed annual amount before dividends may be paid upon the common stock, and this right is cumulative. All of these new rights may be disposed of without affecting the petitioner's pre-existing interest as the holder of the common stock." Brief for the Respondent, pp. 45, 46.

The Commissioner's failure to persuade this Court in the *Sprouse* and *Strassburger* cases[28] is significantly re-

[28] In discussing the *Strassburger* case the Commissioner implies that there the taxpayer intended and continued to hold the dividend shares. However, the facts were different. The apparent purpose of the dividend was to enable the shareholder to make a gift to his wife, and he gave her the newly issued shares five days after he received them. *Emil H. Strassburger,* 1941 P.-H. B.T.A.

vealing here. In both cases the Commissioner argued that the stock dividends should be taxed because they could be expeditiously sold. In rejecting this argument the Court was fully aware that stock dividends are commonly sold after they are received. One of the usual reasons for declaring a stock dividend is to enable the stockholders to sell some of their holdings. Obviously, the decisions in *Eisner* v. *Macomber, supra,* and *Helvering* v. *Griffiths, supra,* would not have been different if the declaration of the dividend had been designed to expedite a sale of dividend shares and if the receipt of the shares had been quickly followed by their sale. Having lost those cases, as well as the *Sprouse* and *Strassburger* cases, the Commissioner now argues that stock dividends which are otherwise tax-free become taxable if they actually are sold. Instead of seeking Congress' assistance if he is dissatisfied, the Commissioner proceeds to sabotage this Court's opinions.

7. The Commissioner does not claim that the decision below is in conflict with a decision of another Court of Appeals.[29] Nor does the decision below raise an important question of law which deserves this Court's special scrutiny. In this connection, the Commissioner does not assert that the decision creates any serious administrative problems for him in the disposition of other pending cases. He merely states that he expects future attempts to minimize

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Memo. Dec. ¶ 41,098. In arguing the *Strassburger* case in this Court, the Commissioner expressly noted that the gift of the dividend rapidly followed its receipt. See Brief for the Respondent, p. 3.

[29] The Commissioner mentions several articles to vindicate his petition. (Pet. 24, n. 6.) Needless to say, articles do not authorize a tax which the Commissioner cannot otherwise justify. However, quite apart from this difficulty, the Commissioner's reference to the articles is less than accurate and complete. The articles leave no doubt that he has wandered well beyond the relevant statutes and far into the domain of policy where only Congress is free to tread.

tax through stock dividends.[30] But future problems are not the kind of present questions which the writ of certiorari was designed to bring here. See *Brown* v. *Allen*, 344 U. S. 443, 491 (1953). And since whatever difficulties the Commissioner may fear are still in the future, he may seek appropriate legislation in Congress rather than burden the courts with complex issues of tax policy. Certainly this Court does not sit to resolve the Treasury's anticipatory administrative problems. The Court's sensitive concern with only those questions which are both immediate and significant is peculiarly fitting amid the endless complexities of tax law. For, as Mr. Justice Reed has so aptly stated, "Judicial efforts to mold tax policy by isolated decisions make a national tax system difficult to develop, administer or observe." *Commissioner* v. *Estate of Church*, 335 U. S. 632, 653 (1949).

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[30] The Commissioner quotes from a letter which his Chief Counsel has written to the Department of Justice. (Pet. 24, n. 6.) This letter does not improve his case for certiorari. The quoted excerpt alludes, in somewhat cloudy fashion, to a so-called "accepted tax policy of the last five years." Apparently the Commissioner is referring to the policy which he pursues when taxpayers request advance rulings on proposed stock dividends. In the last five years he has refused to rule in advance that the profit realized on a sale of preferred stock dividends is capital gain. On the other hand, he has repeatedly so ruled in regard to sales of common stock dividends, whether voting or non-voting. See Darrell, *Recent Developments in Nontaxable Reorganizations and Stock Dividends*, 61 Harv. L. Rev. 958, 961 (1948). We fail to see how the Commissioner's policy with respect to advisory rulings creates a present and important question for adjudication here. The issuance of advance rulings is purely a matter of discretion, which the Commissioner may or may not exercise in the light of various considerations. See Rev. Rul. 10, 1953-2 Cum. Bull. 18; Mim. 4963, 1939-2 Cum. Bull. 459. For example, he may wish to discourage certain transactions despite the absence of legislation by Congress. The Commissioner often refuses to give favorable advisory rulings though the taxpayer would easily succeed in the courts. Surely where the exceptional writ of certiorari is involved, the Commissioner cannot lift himself by his own bootstraps by declining to issue requested rulings.

Moreover, there is no question here which the Court can definitively determine in favor of the Commissioner. Under the statutory scheme devised by Congress a stock dividend is clearly non-taxable if it does not alter the stockholder's proportionate interest, and the profit derived on a sale of the dividend is clearly a capital gain. If for some reason this Court were to hold differently in this case, the lower courts would then have to determine whether a case fell within the established rule or within the newly found exception. Inevitably the Treasury and the courts would be left to struggle in a morass of confusing particularities.

As this Court's decisions readily disclose, the Treasury has struggled with stock dividends almost thirty-five years since *Eisner* v. *Macomber*. The decisions were rendered "after mature consideration"; they were "designed to fashion the governing rule of law"; and they have become the basis for a complex network of subsidiary rules.[21] Cf. *Screws* v. *United States*, 325 U. S. 91, 112 (1945). And see *Apex Hosiery Co.* v. *Leader*, 310 U. S. 469, 487 (1940); *Helvering* v. *Griffiths*, *supra*, at 402; *Walling* v. *Halliburton Co.*, 331 U. S. 17, 25 (1947); *Toolson* v. *New York Yankees*, 346 U. S. 356, 357 (1953). Throughout all the years since *Eisner* v. *Macomber* it has been settled that if a stock dividend does not change a stockholder's proportionate interest, the profit obtained on a sale of the dividend shares is taxable as a capital gain. Otherwise the Treasury would not have labored so hard and so long to tax stock dividends as ordinary income. Though almost eleven years have passed since this Court last spoke on stock dividends,[22] the Treasury has conspicuously failed to request any legislation which would treat stockholders differently. Yet during this same period Congress and the Treasury have

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[21] See Int. Rev. Code §§27(b)(f)(i), 102(d)(2), 113(a)(19)(A), 115(f)(h), 117(h)(5), 335, 362(b)(2), 441(d), 458(d)(f), 504(a)(c), 506(c).

[22] *Helvering* v. *Sprouse*, *supra*, and *Strassburger* v. *Commissioner*, *supra*.

been unusually occupied with tax legislation. Congress has enacted six major tax revisions[33] and other significant amendments.[34] These have included many important changes actively sponsored by the Treasury in order to safeguard the revenues. But despite all the intense legislative activity, the Treasury has steadfastly refrained from asking Congress to reconsider the taxability of proceeds from the sale of stock dividends. At the same time the Treasury has continued to promulgate regulations which articulate the established rules. Regulations 111, §§ 29.113 (a)(19)-1, 29.117-4; Regulations 118, §§ 39.113(a)(19)-1, 39.117(h)-1(b).

The matter does not end there. After an exhaustive study of stock dividends the Committee on Ways and Means has just proposed a remedy for the avoidance which the Commissioner seems to fear. The Committee plans to impose a special "85 percent transfer tax on the corporation" if the dividend shares, after sale, are redeemed within ten years from the date of issuance. The corporation will be taxable at the time of redemption. For the convenience of the Court we set forth the relevant portions of the Committee's analysis and recommendation in Appendix B, *infra*.

For present purposes the Committee's statement is especially illuminating in several respects. First, it indicates that whatever problem exists is plainly for Congress to solve. Only a statute can properly cope with the many intricacies involved. Second, the Committee eliminates any doubt, if any doubt remains, in regard to the correct-

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[33] Revenue Act of 1943, Pub. L. No. 235, 78th Cong., 2d Sess. (1944); Individual Income Tax Act of 1944, Pub. L. No. 315, 78th Cong., 2d Sess. (1944); Revenue Act of 1945, Pub. L. No. 214, 79th Cong., 1st Sess. (1945); Revenue Act of 1948, Pub. L. No. 471, 80th Cong., 2d Sess. (1948); Revenue Act of 1950, Pub. L. No. 814, 81st Cong., 2d Sess. (1950); Revenue Act of 1951, Pub. L. No. 183, 82d Cong., 1st Sess. (1951).

[34] See, *e.g.*, Technical Changes Act of 1949, Pub. L. No. 378, 81st Cong., 1st Sess. (1949); Technical Changes Act of 1953, Pub. L. No. 287, 83d Cong., 1st Sess. (1953).

ness of the decision below. It expressly states that the stock dividend "was not a taxable distribution under existing Supreme Court decisions." Indeed, the Committee intends to continue the present capital gain treatment for stockholders, whether the sale of the stock dividend is prompt or delayed. Third, the proposed solution is a new tax on the corporation rather than the stockholders. In other words, the Committee has refused to impose by legislation the very tax which the Commissioner is now attempting to impose by judicial decision. Fourth, in view of the contemplated legislation, this Court would only labor in vain if it granted certiorari. Even if we rashly assume that the decision below is erroneous, a reversal would not provide any meaningful rule for the future. On the contrary, the decision would be overruled by the legislation.

Few areas in tax law are enmeshed in more defiant difficulties than capital gains and stock dividends. And no technical problems in taxation require a more profound inquiry into "questions of legislative policy bearing on fiscal and economic matters and on administrative convenience." Cf. *Commissioner* v. *Beck's Estate*, 129 F. 2d 243, 246 (2d Cir. 1942). If there are any doubts on this score, we need only refer to the Herculean labors of the American Law Institute. See A. L. I. Federal Income Tax Statute, p. 224 *et seq.* (Tent. Draft No. 7, 1952). In the Institute's view no adequate treatment of stock dividends is possible unless Congress abandons the principle of proportionate interest as the controlling standard of liability.[35] But as the Institute additionally emphasizes, no alternative scheme of taxation is feasible unless Congress also unravels a formidable group of intricate problems in policy and draftsmanship. Courts "have no power to embark on such an enterprise," nor do they have the facilities to succeed. Un-

[35] Under the comprehensive amendments contemplated by the Ways and Means Committee practically all stock dividends would be non-taxable, regardless of whether they alter the stockholders' proportionate interests, and as a result the profit realized on their sale would qualify as capital gain. See Appendix B, *infra*.

like Congress, they may not "roam at large, confined only by the Constitution." *Commissioner* v. *Beck's Estate, supra,* at 245, 246.

The existing provisions on stock dividends are rooted in interrelated premises and policies which Congress has approved and which only Congress can change. "If in practice these sections are causing such loss of revenue as to indicate that Congress may have erred in its balancing of the competing considerations involved, the amendment must obviously be enacted by the Congress and not the Commissioner of Internal Revenue or this Court." *Commissioner* v. *Korell, supra,* at 626. This Court's similar response in *United States* v. *Nunnally Investment Co.,* 316 U. S. 258 (1942), is still more appropriate here. As the Court stated, "such a determination of policy in the administration of the income tax law should be made by Congress, which maintains a Joint Committee on Internal Revenue Taxation charged with the duty of investigating the operation of the federal revenue laws and recommending such legislation as may be deemed desirable." Congress alone "can deal with the matter comprehensively, unembarrassed by the limitations of a litigation involving only one phase of a complex problem." *Id.* at 264. See also *Helvering* v. *Gowran, supra,* at 241-243.

CONCLUSION

The opinion of the Court of Appeals is a thoughtful and painstaking analysis of all the issues in the case. The decision is correct, there is no conflict of decisions, and no question remains to absorb this Court's time and attention. The petition for writs of certiorari should therefore be denied.

Respectfully submitted,

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APPENDIX A

Internal Revenue Code:

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of property.*—The basis of property shall be the cost of such property; except that— • • •

(19) *Property acquired by corporate stock distribution.*

(A) If the property was acquired by a shareholder in a corporation and consists of stock in such corporation, or rights to acquire such stock, acquired by him after February 28, 1913, in a distribution by such corporation (hereinafter in this paragraph called "new stock"), or consists of stock in respect of which such distribution was made (hereinafter in this paragraph called "old stock") and • • •

(ii) the new stock was acquired in a taxable year beginning after December 31, 1935, and its distribution did not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution;

then the basis of the new stock and of the old stock, respectively, shall, in the shareholder's hands, be determined by allocating between the old stock and the new stock the adjusted basis of the old stock; such allocation to be made under regulations which shall be prescribed by the Commissioner with the approval of the Secretary.

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(26 U.S.C., 1945 ed., Sec. 113.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter • • • means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed

as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. • • •

• • • • • • •

(f) *Stock Dividends.*—

(1) *General rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

• • • • • • •

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

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(26 U. S. C., 1945 ed., Sec. 115.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—• • •

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;[1]

• • • • • • •

(h) *Determination of Period for Which Held.*—For the purpose of this section—

• • •

(5) In determining the period for which the taxpayer has held stock or rights to acquire stock received upon a distribution, if the basis of such stock or rights is determined under section 113 (a) (19) (A), there shall

[1] This provision is quoted as it read before amendment by Revenue Act of 1951, § 322(c)(2), 65 Stat. 500.

(under regulations prescribed by the Commissioner with the approval of the Secretary) be included the period for which he held the stock in the distributing corporation prior to the receipt of such stock or rights upon such distribution.

* * * * * * *

(26 U. S. C., 1945 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec 29.113(a)(12)-1. *Basis of Property Established by Revenue Act of 1932.*—* * *

(2) If the stock distributed in reorganization is in whole or in part stock in a corporation a party to the reorganization other than the distributing corporation, or where the stock distributed in reorganization is in whole or in part stock of a character or preference materially different from the stock in respect of which the distribution is made, or if the distribution consists wholly or partly of securities other than stock, the cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock or securities distributed in proportion, as nearly as may be, to the respective values of each class of stock or security, old and new, at the time of such distribution, and the basis of each share of stock or unit of security will be the quotient of the cost or other basis of the class of stock or security to which such share or unit belongs, divided by the number of shares or units in the class. Within the meaning of the foregoing provisions, securities are different in class from stocks and stocks or securities in one corporation are different in class from stocks or securities in another corporation. In general, any material difference in character or preference or terms sufficient to distinguish one stock or security from another stock or security so that different values may properly be assigned thereto, will constitute a difference in class.

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Sec. 29.113(a)(19)-1. *Basis of Stock and Rights Involved in the Acquisition of Stock Dividends or Stock Rights: General Rules.*—(a) *Stock dividends.*—In the

case of stock * * * in respect of which was acquired in a taxable year beginning after December 31, 1935, a stock dividend which did not constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution, the basis for determining gain or loss from a sale or other disposition of either the stock in respect of which the distribution was made or the stock dividend shall . . . be ascertained in accordance with the principles set forth in section 29.113(a)(12)-1.

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Sec. 29.115-1. *Dividends.*—* * *

The term "dividend" does not include distributions under * * * section 115 (f), relating to stock dividends * * *.

* * * * * *

Sec. 29.117-4. *Determination of Period for Which Capital Assets are Held.*—* * *

The period for which the taxpayer has held stock * * * issued to him as a dividend shall be determined as though the stock dividend * * * were the stock in respect of which the dividend was issued if the basis for determining gain or loss upon the sale or other disposition of such stock dividend * * * is fixed by the apportionment of the basis of such old stock.

* * * * * *

APPENDIX B

General Tax Revision[1]

Committee on Ways and Means: Chairman Reed announced that the following substantive changes were agreed to during today's consideration of the general revenue revision bill for 1954—

Corporate Distributions and Adjustments

Adopted a series of provisions which substantially revise the tax treatment of corporate distributions and adjustments. These changes are designed to provide a more orderly treatment of these problems. Some of the more important features of the new provisions of the committee proposals are discussed below.

1. *Corporate distributions of stock.*—Under present law it is clear that a stock dividend of common stock on common stock is not taxable as a dividend. The tax treatment of other types of stock distributions, however, is uncertain. The committee, to clarify the tax treatment of these other distributions, adopted a provision allowing a corporation to distribute tax free its own stock (or rights to this stock) to the greatest possible extent. In general all distributions made by a corporation of its own stock are to be tax free unless they are in lieu of payments for dividends on preferred stock or interest on bonds. Where a stockholder has a choice between receiving money or stock, any stock distributions are to continue to be taxable as under existing law.

2. *Preferred stock "bail out."*—The committee acted to prevent tax avoidance which otherwise might occur as a result of the recent court decision in the Chamberlin case. In this case a dividend in preferred stock was declared to a stockholder who controlled the company. This was not a taxable distribution under existing Supreme Court deci-

[1] 100 Cong. Rec. D76 (Jan. 28, 1954).

sions. The preferred stock was sold by the stockholder to another person and the corporation immediately redeemed the preferred stock for cash.[2] In effect, the stockholder received a share of the earnings and profits of the corporation, but, instead of being taxed at ordinary tax rates on these earnings, paid only a capital gains tax. The Committee adopted a provision which stops this avoidance device by imposing an 85-percent transfer tax on the corporation at the time it redeems the preferred stock within 10 years of the time the stock was issued unless—(a) the redemption was made in liquidation (complete or partial) of the corporation; (b) at the time of the redemption of the stock there is a proportionate redemption of the stock on which the preferred stock was issued; (c) the redemption was of preferred stock issued for a contribution of property (but then only to extent of 105 percent of the value of the property); (d) the redemption is treated as a dividend; or (e) the redemption is made to pay death taxes.

* * * * * *

[2] This sentence is not entirely correct. The preferred stock in this case was gradually redeemable over 7 years and 4 months if profits were available, and the first redemption did not take place until 1 year and 4 months after issuance of the stock.